86-416 (1)

Supreme Court, U.S.
FILED
AUG 25 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1986

VIRGINIA Z. HARWOOD, MORRIS J. HARWOOD MARGARET P. HARWOOD and ARTHUR H. HARWOOD,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

On a Writ of Certiorari from the Court of Appeal for the Ninth Circuit

---

Petition for Certiorari

John Gigounas, Esq.
(Counsel of Record)
Edward B. Simpson, Esq.
SIMPSON GIGOUNAS BOOHER & HOLMES
50 California Street
Suite 3150
San Francisco, CA 94111
(415) 391-4900
Attorneys for Petitioners

August 21, 1986

132 pp

No._____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1986

VIRGINIA Z. HARWOOD, MORRIS J. HARWOOD MARGARET P. HARWOOD and ARTHUR H. HARWOOD,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

On a Writ of Certiorari from the Court of Appeal for the Ninth Circuit

---

Petition for Certiorari

John Gigounas, Esq.
(Counsel of Record)
Edward B. Simpson, Esq.
SIMPSON GIGOUNAS BOOHER & HOLMES
50 California Street
Suite 3150
San Francisco, CA 94111
(415) 391-4900
Attorneys for Petitioners

August 21, 1986

QUESTIONS PRESENTED

Special and important questions of federal law presented for review are as follows:

1. Whether as a matter of law Federal gift tax on the transfer of a partnership interest is restricted to a formula price fixed by the partnership agreement.

2. Whether valuation of an operating company for federal gift tax purposes must take into account earning capacity.

Parties to Proceeding Below

All parties appear in the caption of the case as set forth above.

TABLE OF CONTENTS

	Page
OPINIONS BELOW	2
JURISDICTION	2
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	3
STATEMENT OF CASE	3
ARGUMENT I	6
ARGUMENT II	12
CONCLUSION	14
APPENDIX A	17
APPENDIX B	102
APPENDIX C	122
PROOF OF SERVICE	124

TABLE OF AUTHORITIES

Cases	Page(s)
Andrews, Estate of v. Commissioner, 79 T.C. 938 (1982)	13
Berzon v. Commissioner, 65 T.C. 601 (1974), aff'd 534 F.2d 528 (2nd Cir. 1976)	8
Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955)	8
Harwood, Virginia, et al., v. Commissioner of Internal Revenue, 82 T.C. 239 (1984)	2
James v. Commissioner, 3 T.C. 1260 (1944), aff'd 148 F.2d 236 (2nd Cir. 1945)	8
Lomb v. Sugden, 82 F.2d 166 (2nd Cir. 1952)	8
Reynolds, Estate of v. Commissioner, 55 T.C. 172 (1980)	8, 11,
Seltzer, Estate of v. Commissioner, T.C. Memo 1985-519	8
Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946)	8
Weil, Estate of v. Commissioner, 22 T.C. 1267 (1954)	8

Wilson v. Bowers, 57 F.2d 682 (2nd Cir. 1952) 8

Constitutional Provisions

Article III 2

Federal Statutes

Title 26 U.S.C. 2512 3

Internal Revenue Code

Section 7482 4

Treasury Regulations

Section 25-2512-1 7
Section 25-2512-3 13

Revenue Rulings

Rev. Rul. 59-60, 1959-1 C.B. 237 13

In the Supreme Court of United States

October Term 1986

No._____

VIRGINIA Z. HARWOOD, MORRIS J. HARWOOD MARGARET P. HARWOOD and ARTHUR H. HARWOOD,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

On a Writ of Certiorari from the Court of Appeal for the Ninth Circuit

---

Petition for Certiorari

The petitioners herein respectfully pray that a writ of certiorari issue to review the Ninth Circuit's affirmance of a decision of the United States Tax Court, with petition for rehearing denied May 28, 1986.

OPINIONS BELOW

The decision of the United States Tax Court in Virginia Harwood, et al., v. Commissioner of Internal Revenue, 82 T.C. 239 (1984) was affirmed by the Ninth Circuit March 18, 1986, in an unpublished opinion, with petition for rehearing denied May 28, 1986. The Tax Court and Ninth Circuit opinions are printed in Appendix A and B hereto. The denial of rehearing is printed in Exhibit C.

Jurisdiction

This case involves special and important questions of federal tax law and jurisdiction to review the determination of the Ninth Circuit Court of Appeals is conferred by Article III of the United States Constitution. This petition is timely in that such was

mailed to the Court within 90 days of May 28, 1986, the date when rehearing was denied.

Constitutional and Statutory Provisions Involved

The federal statutory provision involved is Title 26 U.S.C. 2512. Subsection (a) of Section 2512 states: "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

No constitutional provisions are directly involved.

Statement of the Case

The relevant facts of this case are set forth as follows:

A. Course of proceedings in the case now before this Court.

This case arose upon petitions to

the United States Tax Court for redetermination of gift tax deficiencies. The Tax Court opinion was filed February 8, 1984 as 82 T.C. No. 23. Issues presented herein were appealed to the Ninth Circuit. The Tax Court was affirmed by the Ninth Circuit on March 18, 1986, with rehearing denied on May 28, 1986, respectively. The Ninth Circuit had jurisdiction on the appeal under IRC Section 7482(a)

B. Relevant Facts Concerning Questions Presented.

1. Partnership provision restriction

Virginia and Arthur (Bud) Harwood are husband and wife. Margaret and Morris (Jack) Harwood are husband and wife. The Harwoods have interests in business entities which own timberlands and mill timber into lumber and related wood products. Harwood Investment

Company (HIC) is one such entity.

On January 1, 1973 and on December 31, 1976 the Harwoods transferred certain partnership interests in HIC to other family members. The partnership agreements specifically provided that, if a partner should withdraw, the remaining parties had the option of buying the interest of the withdrawing partner at "book value" exercisable at the end of the calendar quarter involved. The IRS determined gift tax based upon value substantially in excess of book value contending that the book value provisions are not binding for gift tax purposes. Over a million dollars in tax and interest is involved.

2. Operating Company Valuation

HIC was an operating company generating millions annually in revenue. IRS determined value for gift tax on HIC

partnership interest transfers based upon net asset values. Petitioners contended value should be based primarily upon earnings capitalization. The Tax Court totally rejected earnings as a factor to be taken into account in determining value. IRS presented no expert evidence concerning earnings and for net asset values relied upon a pre-litigation asset value (comparable sales) report of HIC. Petitioners presented expert evidence on value based upon earnings, also taking into account net asset values. The Ninth Circuit affirmed the Tax Court in whole.

ARGUMENT

I. Partnership Restrictive Provision

This case presents a very important question of federal tax law. Under indentical or similar factual situations, a valuation determination for estate tax

purposes is treated differently than it is for gift tax purposes.

The value of interests transfered for gift tax purposes is their fair market value. Fair market value is the price at which property would change hands between the hypothetical willing buyer and the hypothetical willing seller, neither being under compulsion and both having reasonable knowledge of the facts. Treas. Reg. Section 25-2512-1.

In estate tax situations, the cases hold that where, at the date of valuation, a deceased person is subject to immediate divestiture by virtue of a restrictive provision allowing for buy-out at a fixed price, the price is binding for tax valuation purposes. This is because the hypothetical willing buyer would not pay more than the fixed price because the buyer could be immediately

BEST AVAILABLE COPY

bought out for the fixed price. See Wilson v. Bowers, 57 F.2d 682 (2nd Cir. 1952); Lomb v. Sugden, 82 F.2d 166 (2nd Cir. 1952); Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Estate of Weil v. Commissioner, 22 T.C. 1267 (1954); Estate of Seltzer v. Commissioner, T.C. Memo 1985-519.

In gift tax situations, the Courts hold that such provisions are not binding on value because upon transfer the fixed price does not account for the value of all rights inherent in ownership. See Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946); James v. Commissioner, 3 T.C. 1260 (1944), aff'd 148 F.2d 236 (2nd Cir. 1945); Berzon v. Commissioner, 65 T.C. 601 (1974), aff'd 534 F.2d 528 (2nd Cir. 1976). See also lengthy discussion in Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970). Accordingly,

restrictive agreements in estate tax cases are being treated differently than those in gift tax cases as a matter of law.

The Tax Court in Harwood held that the restrictive provisions do not establish value per se because the interests "carried with them rights additional to the rights of their holders to receive certain payments upon withdrawal from HIC." The Tax Court never explained what additional rights would be involved in Harwood. The Ninth Circuit affirmed quoting the Tax Court as above. The elusive "additional rights" are not identified.

Petitioners argued below and contend here that the rule that restrictive agreements are not binding in gift tax situations is not correct as a matter of law and that such a rule of law applied

to a gift tax situation is discriminatory because under essentially the same situation a restrictive provision is deemed binding for estate taxes.

In this case, petitioners argue that under the partnership agreement affecting 1976 they were subject to immediate divestiture, on December 31, 1976, the date of the transfer. The rational supporting estate tax restrictions should apply with respect to the transfer.

For the 1973 transfer, petitioners were subject to diverstiture within three months. Thus while in 1973 there may have been some rights over a three month period, the lower Courts did not deal with the value, if any, of ownership during the three months, but simply applied per se the rule that restrictive provisions are not binding in gift tax situations.

Restrictive agreements in estate and gift tax cases have a confused history. See Estate of Reynolds v. Commissioner, supra. The confusion appears traceable to a misunderstanding concerning the effect of a restriction on a gift which will not become effective until some future time and a restriction that is presently operable and which is triggered by a transfer. Estate of Reynolds, supra. An example of the former would be a gift subject to a buy-out if one later leaves employment or one that is subject to buy-out upon death. An example of the latter would be an option to buy in the event of any transfer.

The restrictions in the case at issue are a combination of conditions, one of which is withdrawal. The event of withdrawal by gift is of course also the very event that would trigger the right

of the remaining partners to buy at book value.

The theory that a value is not fixed by a formula, e.g. "book value", where the event will occur in the future makes sense in that the donee can be expected to have an indeterminate period of unconditional use depending upon the circumstances. However, where the gift transfer also triggers the buy-out provision, the donee is immediately subject to divestiture by election and, if the value exceeds the buy-out amount, e.g., "book value", it can reasonably be assumed that the donee will be bought out. Thus, the value of the transfer in such a case is limited to the formula, which in this case is "book value".

ARGUMENT II

The Tax Court totally rejected

petitioners position that earnings in an operating company must be taken into account in valuation of interests in a company. The Ninth Circuit affirmed.

This action was contrary to well established law and Treasury regulations. See Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Rev. Rul. 59-60, 1959-1 C.B. 237; Treas. Regs. 25.2512-3.

Moreover, the Ninth Circuit memorandum denied petitioners due process under the 5th Amendment in exercising its appellate powers.

In the Ninth Circuit opinion the Court states "petitioners do not contend that the report's authors are unqualified or that the report is unsound." (Emphasis added)

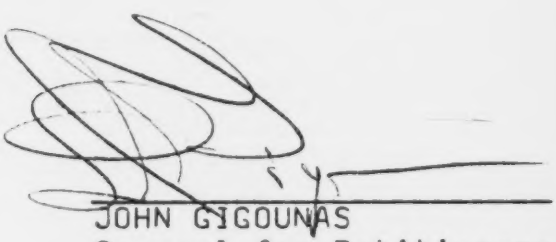
The Ninth Circuit is referring to the Kleiner-Granvall report relied upon

by IRS and the report adopted by the Tax Court. The entire record of this case dealt with petitioners' proof that the Kleiner-Granvall report was unsound and that Kliener and Granvall were not qualified.

CONCLUSION

This case involves very important questions concerning valuations for federal gift tax puposes. A writ of certiorari should be granted.

Dated: 8/25/86



JOHN GIGOUNAS
Counsel for Petitioners

No._____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1986

VIRGINIA Z. HARWOOD, MORRIS J. HARWOOD MARGARET P. HARWOOD and ARTHUR H. HARWOOD,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

Appendix to Petition On a Writ of Certiorari from the Court of Appeal for the Ninth Circuit

---

CONTENTS OF APPENDIX

Page

APPENDIX A - UNITED STATES TAX COURT DECISION.....17

APPENDIX B - MEMORANDUM FROM THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.....102

APPENDIX C - ORDER FROM THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.....122

82 T. C. No. 23
UNITED STATES TAX COURT

VIRGINIA Z. HARWOOD, ET AL., [1]
PETITIONERS
v. COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 6557-81, 6558-81,
6559-81, 6560-81,
6561-81.
Filed February 8, 1984

On January 1, 1973 A, mother of B, C, and D, transferred to B and C. her interest in the family partnership, in exchange for a note. On that same date, the partnership interests of B, C,and D were adjusted to give D an additional one-eighteenth interest and to reduce B and C's interest correspondingly.

On December 29, 1976, B and C formed trusts for the benefit of their children and transferred thereto 8.89-percent limited parnership interests in the family partnership. The family partnership agreement contained a restrictive clause entitling the partnership to buy out withdrawing partners at book value under certain circumstances. The trust agreements contained a savings clause providing

---

[1] Cases of the following petitoners are consolidated herewith: Belva Y. Harwood, docket No. 6558-81; Morris J. Harwood, docket No. 6559-81; Margaret P. Harwood, docket No. 6560-81; and Arthur H. Harwood, docket No. 6561-81.

that under certain circumstances, the trustees could issue notes to B and C to reduce the size of the gifts made by B and C to their respective trusts.

Held, the January 1, 1973 transactions between A and B and C, and between B and C and D, were taxable gifts to the extent that the property transferred exceeded in value the consideration received therefor. Held further, the impact upon value of the restrictive clause in the family partnership agreements determined. Held further, the value of the 1973 and 1976 gifts of interests in the family partnership determind. Held further, the savings clause in the trusts does not affect the gift taxes otherwise determined.

Edward B. Simpson and John S. Convery, for the petitioners.

Neal O. Abreu and David L. Denier, for the respondent.

FORRESTER, Judge: Respondent determined deficiencies in gift taxes for the petitioners in these cases as follows:

Docket No./ Petitioner	For Calendar Quarter Ended:/	Deficiency
6557-81	3/31/73	$40,787
Virginia Z. Harwood	12/31/76	209,786
6558-81	3/31/73	580,640
Belva Y. Harwood		

Docket No./ Petitioner	For Calendar Quarters Ended:/	Deficiency
6559-81	3/31/73	91,888
Morris J. Harwood	12/31/76	221,848
	12/31/78	12,420
	12/31/79	16,210
6560-81	12/31/76	189,558
Margaret P. Harwood		
6561-81	3/31/73	40,787
Arthur H. Harwood	12/31/76	209,786

After concessions, the issures for our decision are:

(1) Whether Belva Harwood made a gift in 1973 to her sons, Arthur H. and Morris J. Harwood, of a minority partnership interest in Harwood Investment partnership;

(2) Whether Arthur and Virginia Harwood and Morris J. Harwood gave in 1973 a minority parnership interest in Harwood Investment partnership to Mary Suzanne Harwood Rubattino;

(3) Whether restrictive provisions

contained in partnership agreements of Harwood Investment Company on January 1, 1973, and December 29, 1976, are binding upon respondent in determining the fair market value of the interests in Harwood Investment Company for gift tax purposes;

(4) What is the fair market value of the limited partnership interests in Harwood Investment Company given to the Arthur H. and Morris J. Harwood family trusts on December 29, 1976;

(5) What are the fair market values of the minority partnership interests in Harwood Investment Company transferred on January 1, 1973, by Belva Harwood, Arthur H. and Virginia Harwood, and Morris J. Harwood;

(6) Whether the savings clauses in the Arthur H. Harwood 1976 family trust

and in the Morris J. Harwood 1976 family trust limiting the amount of the gifts made by the respective grantors in the event of IRS challenge are enforceable so as to avoid gift tax on completed gifts of interests in Harwood Investment Company to the two trusts.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

When the petitions in these cases were filed, Virginia Z. Harwood (hereinafter Virginia) and Arthur H. Harwood (hereinafter Bud) resided in Branscomb, California, Belva Y. Harwood (hereinafter Belva) resided in Santa Rosa, California, and Morris J. Harwood (hereinafter Jack) and Margaret P.

Harwood (hereinafter Margaret) reside in Willits, California. Virginia was married to Bud during the years at issue, and Margaret was married to Jack during the years at issue. Belva is the mother of Jack and Bud, and of Mary Suzanne Harwood Rubattino (hereinafter Suzanne).

In 1953, Arthur Harwood, Sr. (hereinafter Arthur), the father of Bud, Jack, and Suzanne, started a small sawmill in Branscomb, California. In 1955, the sawmill was operated as a partnership under the trade name "Branscomb Enterprises," with Arthur, Bud, and Jack, general partners, and Jack, as trustee for Suzanne, a limited partner. Branscomb Enterprises business was the operation of the sawmill, which converted logs to lumber and other milled forest products.

On January 1, 1955, Arthur, Bud,

and Jack formed Harwood Investment Company (hereinafter HIC), a partnership. Each held a one-third general partnership interest in HIC. The partnership interest in Arthur's name was the community property of Arthur and Belva.

The partnership agreement included the following clauses;

> ELEVENTH: DISSOLUTION AND LIQUIDATION. If during the existence of the parnership a partner shall die or be declared incompetent, the remaining partners agree, subject to the provisions of this paragraph ELEVENTH, to continue the business of the partnership until the end of the year in which such event or events shall occur, and such death or incompetence shall not immediately dissolve the partnership, and the continuing partnership shall be the same partnership for all purposes until the end of said year. It is the intention of the parties that the partnership shall continue through the then current year, and that no decrease in the personnel thereof shall effect a dissolution of the partnership until the end of said year unless the partnership shall be terminated as hereinbelow specifically provided.
>
> Each partner agrees for himself

and hereby obiligates his heirs, executors, administrators and assigns to permit the partnership to use (subject to the terms of this agreement) his contribution in or to the business for the uses herein specified, until the dissolution of the partnership.

In the event of death or incompetence of a partner, the remaining partners may elect at their option at the end of the year in which such event or events occur to form a successor partnership and to continue the partnership business, in which event full payment shall be made in cash by the said successor partnership within one year for the amount of the book value of the interest of such deceased or incompetent partner. "Book Value" for this purpose includes the partner's capital contribution, his loans (if any) to the partnership, and his share in any unwithdrawn partnership profits, adjusted for his share in any undivided partnership loss, all as set forth in the duly audited partneship balance sheet at the end of the year in question. In the determination of said book value no allowance shall be made or included for "good will" or unrealized appreciation of partnership property or actual depreciation in excess of depreciation recorded in the partnership books of account.

If any partner shall withdraw or be adjudicated a bankrupt during the existence of the partnership, the remaining partners shall have the same rights and duties as if the withdrawing or bankrupt partner had died upon such date, except that any successor

partnership may, at its election, pay the book value of the interest of the said withdrawing or bankrupt partner in four equal annual installments, without interest, the first such installment to be due on the ninetieth (90th) day after the end of the year in which such event shall occur.

* * *

Notwithstanding any other provision of this agreement, it is expressly agreed that in the event of the death, incompetence, withdrawal or bankruptcy of ARTHUR P. HARWOOD, BELVA HARWOOD, his wife, may at her option acquire the said ARTHUR HARWOOD'S interest upon terms no less favorable to her than the terms set forth herein, and thereafter the said BELVA HARWOOD shall be an equal partner in this partnership. To exercise this option the said BELVA HARWOOD shall give written notice to the other partners at the principal place of business of the partnership within ninety (90) days after the death, withdrawal, or adjudication of bankruptcy or incompetence of the said ARTHUR HARWOOD.

HIC acquires and holds timberland, timber rights and other properties.

On or about July 1955, Harwood Logging Company, a corporation, was formed by Arthur, Bud and Jack, each holding a one-third interest. Harwood Logging Company purchases timber

acquired and held by HIC and cuts it into logs.

Sometime in the early 1970's, Branscomb Enterprises changed its name to Harwood Products Company, a limited partnership. Harwood Products Company continued to purchase logs and operate the sawmill which converts the logs to lumber and other milled forest products.

On July 16, 1955, Arthur executed his last will and testament. Belva concurrently executed a document which was attached to the will. In the third paragraph of his will, Arthur Harwood, Sr. directed that his entire separate estate and all the community property, including his wife's share therein, was to pass to a testamentary trust. In a document attached to the will, Belva consented in writing to the provisions of the aforementioned will whereby Arthur disposed of all of their community

property. Arthur provided in the sixth paragraph of his will that should his wife revoke the aforementioned consent and elect to take her statutory share in lieu of the provisions made for her in the will, then the will was to be given effect as if Belva had predeceased Arthur, except as to certain bequests made to her in the second paragraph of the will.

On March 8, 1958, Arthur Harwood, Sr. died from a stroke. He was survived by Belva and his three children, Bud, Jack, and Suzanne. Arthur's will was admitted to probate in the Superior Court of the State of California for the County of Mendocino.

In 1971, Belva withdrew her consent to dispose of her share of community property by her husband's will. Pursuant to a December 3, 1971 order of the Superior Court of the State of

California for the County of Mendocino, Belva received a one-half interest in the community property held in trust. Since Arthur was a one-third partner in HIC at the time of his death, Belva rceived a one-sixth interest pursuant to the 1971 court order.

Upon Belva's election to take against the will and pursuant to the provisions of the will, the remaining one-sixth interest in HIC was divided into equal shares for Bud, Jack and Suzanne as follows:

Bud	1/3 of 1/6 interest (or 1/18 int)
Jack	1/3 of 1/6 interest (or 1/18 int)
Suzanne	1/3 of 1/6 interest (or 1/18 int) (held in trust until she reached the age of 35 which occurred September 1, 1976.)

On January 1, 1973, Belva transferred her one-sixth interest in HIC to her two sons, Bud and Jack, in equal shares, in exchange for a promissory note in the amount of

$573,365 to be paid in four equal annual installments without interest. Subsequently, Belva exchanged the promissory note for a lifetime annuity from Bud and Jack.

On January 1, 1973, an additional one-eighteenth interest in HIC was transferred to Suzanne.

Upon acquisition by Bud and Jack of Belva's one-sixth interest on January 1, 1973, and upon the transfer to Suzanne of one-eighteenth interest on said date, the partnership interest in HIC were as follows:

Partner	Partnership Interest
Bud	4/9
Jack	4/9
Suzanne	1/9

The transfer of this additonal one-eighteenth interest to Suzanne was due to her desire to increase her participation in HIC, and Bud and Jack's acquiescence to her desire. John

Convery (hereinafter Convery), a C. P. A. and attorney employed by the Harwood family for many years, handled the details of the transaction. The books and records of HIC after January 1, 1973 reflect a one-ninth interest held by Suzanne. No money was transferred by Suzanne to HIC in 1973, nor was there any written agreement that Suzanne would pay any amount for the above one-eighteenth interest in HIC which she acquired on January 1, 1973.

On October 19, 1978, Suzanne paid $300,000 to HIC, which was credited to her drawing account. This $300,000 payment occurred after an IRS agent pointed out to Convery that Suzanne had paid no money in exchange for the interest in HIC that she acquired on January 1, 1973.

On January 1, 1973, a new partnership agreement for Harwood

Investment was executed, which provides in pertinent part:

ARTICLES OF COPARTNERSHIP
OF
HARWOOD INVESTMENT CO.

This agreement of Partnership made and entered into this 1st day of Jan., 1973, by and among ARTHUR H. HARWOOD, MORRIS JACKSON HARWOOD and SUZANNE HARWOOD RUBATTINO, who mutually associate themselves together as partners, and do hereby form and constitute themselves a partnership under the laws of the State of California for the purpose of investing in, acquireing and operating farm lands and other real properties, including participation in joint ventures for similar or related purposes, and for the further purpose of conducting any lawful business activity, in the County of Mendocino and elsewhere, from and after the date hereof until terminated as set forth hereinafter or otherwise.

FIRST: Location of Business. The principal place of business shall be in Branscomb, County of Mendocino, State of California.

SECOND: Capital. The partnership capital shall consist of cash and other assets as set forth in Exhibit A.

THIRD: Managing Partners. Arthur H. Harwood and Morris J. Harwood are hereby appointed managing partners.

During the existence of this partnership the managing partners shall have ultimate authority to make and execute such decisions as they shall deem advisable with respect to the business operations for which this partnership has been organized. In the event of the death of either managing partner, the survivor shall act as managing partner.

* * *

FIFTH: Profits. As soon as practicable after the end of each calendar year, the net profits from the partnership for such year shall be determined. Net profits shall be deemed to be the result after deducting from gross profits all expenses incident to the conduct of the business, interest on moneys borrowed, salaries to partners, all losses, and such other charges, expenses and deductions against gross profits as are properly chargeable hereunder or in accordance with good accounting practice. The remaining net profits, if any there be, shall be divided equally among the partners as follows:

Arthur H. Harwood - 4/9ths
Morris J. Harwood - 4/9ths
Suzanne Harwood Rubattino - 1/9th

SIXTH: Losses and Liabilities. If the partnership shall suffer a net loss for any year, such loss shall be charged against the capital accounts of the partners in the same proportion as set forth for profits in Paragraph FIFTH above.

* * *

EIGHTH: Partnership Books. The partners shall keep or cause to be kept full and accurate books of account for the partnership business, all of which books shall at all times be open to the inspection and examination of each of the partners. Such books shall be examined by a reputable public accountant at least once a year so that the net profits or losses made by the partnership shall be ascertained, apportioned, and credited to or charged against the respective partners.

NINTH: Duties of Partners. (a) No partner shall make, draw, endorse, accept, sign or execute any promissory note, draft, bill of exchange, bond, obligation, commercial paper or other material obligaton, or become surety in any way or form whatsoever, in his own name or in the name of the partnership for the accommodation of any firm, person or coporation.

(b) No partner shall engage or be interested in any business which gives him an interest adverse to the partnership.

(c) Each partner shall devote his time, energy and skill to the best of his ability for the interest, profit, benefit and advantage of the partnership.

TENTH: Dissolution and Liquidation. If during the existence of the partnership a partner shall die or

be declared incompetent, the remaining partners agree, subject to the provisions of this Paragraph TENTH, to continue the business of the partnership until the end of the quarter during which said partner becomes incompetent or dies, and the continuing partnership shall be the same partnership for all purposes until the end of said quarter. The quarters are measured on the calendar year, i.e., March 31, June 30, September 30, and December 31. It is the intention of the parties that the partnership shall continue through the then current quarter and that no decrease in the personnel thereof shall effect a dissolution of the partnership until the end of said quarter unless the partnership shall be terminated as hereinafter specifically provided.

Each partner agrees for himself and hereby obligates his heirs, executors, administrators and assigns to permit the partnership to use (subject to the terms of this agreement) his contribution in or to the business for the uses herein specified, until the dissolution of the partnership.

In the event of death or incompetence of a partner, the remaining partners may elect at their option at the end of a quarter in which such event or events occur to form a successor partnership and to continue the partnership business, in which event full payment shall be made in cash or in the form of a promissory note by the said successor partnership within one year for the amount of the book value of

the interest of such deceased or incompetent partner. "Book Value" for this purpose includes the partner's capital contribution, his loans (if any) to the partnership, and his share of any unwithdrawn partnership profits, adjusted for his share in any undivided partnership loss, all as set forth in the duly audited partnership balance sheet at the end of the quarter in question. In the determination of said book value no allowance shall be made or included for "good will" or unrealized appreciation of partnership property or actual depreciation in excess of depreciation recorded in the partnership books of account.

If any partner shall withdraw or be adjudicated a bankrupt during the existence of the partnership, the remaining partners shall have the same rights and duties as if the withdrawing or bankrupt partner had died upon such date, except that any successor partnership may, at its election, pay the book value of the interest of the said withdrawing or bankrupt partner in four equal annual installments, without interest, the first such installment to be due on the ninetieth (90th) day after the end of the year in which such event shall occur. Said payments may be in the form of cash or interest-bearing promissory notes.

The partnership may be dissolved at any time by a majority in interest of all partners, in which event they shall give written notice to the other partner of their election to dissolve by

addressing the same to said partner at his last known address according to the partnership records, and depositing the same in the United States mail, postage prepaid. The notice shall specify the date fixed for the dissolution of the partnership, and, upon such date, the partnership shall be dissolved and liquidated in the manner provided hereinafter.

Upon complete liquidation of the partnership assets, funds thus realized shall be first applied to pay partnership debts, and any excess shall be distributed among the partners in accordance with their respective entitlements. In the event that installment distributions are made, no partner shall receive any installment distribution large enough to reduce his investment in the partnership below an amount at least equal to his share of any possible loss, and a sufficient reserve to meet probable expenses shall be maintained at all times.

ELEVENTH: Arbitration. All partners agree that they will do their utmost in all circumstances and conditions to make an amicable adjustment of any dispute or controversy which may arise among them during the continuance of this partnership, and in accounting or settlements to be made on liquidation, and that no one of them will in any circumstances bring any action, either at law or in equity, for the dissolution of this partnership or for any other legal or equitable relief. If at any time a dispute arises

involving the accounts, the issues shall be submitted for settlement to such public accountant as may be mutually agreed upon, and if a dispute arises as to other matters, the issues shall be submitted for settlement to such public accountant and to such attorney as may be mutually agreed upon, with power lodged in them to select a third party in case of a disagreement, and the partners agree that the decision of any such arbitration shall be binding upon each of them.

On December 29, 1976, Bud and Virginia created a trust entitled "The Arthur H. Harwood 1976 Family Trust" for the benefit of their four children, with the Bank of America NT & SA acting as the trustee. As of December 29, 1976, Bud's four-ninths interest in HIC was the community property of Arthur H. Harwood and Virginia Z. Harwood.

On December 29, 1976, Jack and Margaret created a trust entitled "The Morris J. Harwood 1976 Family Trust" for the benefit of their four children with Bank of America NT & SA acting as

trustee. For all times material hereto, Morris J. Harwood's four-ninths interest in HIC was his separate property.

Each of the aforementioned trust agreements contained the following clause:

> Article FIRST. Property subject to this instrument listed in Schedule "A" is referred to as the "trust estate" and shall be held, administered, and distributed in accordance with this instrument. In the event that the value of the partnership interest listed in Schedule "A" shall be finally determined to exceed $400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower value is not reasonably defendable, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and $400,000. The note shall carry interest and be effective as of the day of the gift. [Emphasis supplied.]

Also on December 29, 2976, Harood Investment Company, a limited partnership, was duly formed and certificate recorded, to succeed Harwood

Investment Company, a general partnership. Bud and Jack were the general partners for stated percentage interests, and they also were limited partners for stated percentage interests. Bank of America NT & SA, trustee of the Arthur H. Harwood 1976 family trust, Bank of America NT & SA, trustee of the Morris J. Harwood 1976 family trust, and Suzanne were limited partners, each for stated percentage interests. The partnership agreement provided in pertinent part:

LIMITED PARTNERSHIP AGREEMENT

ARTHUR H. HARWOOD and MORRIS J. HARWOOD of Mendocino County herein called General Partners and Bank of America NT & SA trustee of the Morris J. Harwood 1976 Family Trust and Suzanne Harwood Rubattino, herein called Limited Partners agree that:

ARTICLE I.
NATURE OF PARTNERSHIP

1.01 They hereby form a

Limited Partnership, herein called "The Partnership," pursuant to the provisions of Chapter 2, Title 2 of the Corporations Code of the State of California, known as the "Uniform Limited Partnership Act" of California.

1.02 The name of the partnership shall be Harwood Investment Company.

1.03 The Partnership shall engage in the business of investing in, acquiring and operating farm lands and other real properties, including participation in joint ventures for similar or related purposes, and for the further purposes of conducting any lawful business activity.

1.04 The principal place of business of the Partnership shall be at Branscomb, Mendocino County, California, or at such other place or places within Mendocino County, California as may be determined by the General Partners by the giving of written notice of change of address of the principal place of business of the Partnership to each Limited Partner at least 30 days before such change.

1.05 The Partnership shall commence on the recording of a Certificate of Limited Partnership in the manner required by the Uniform Limited Partnership Act and shall continue until terminated as herein provided.

ARTICLE II
MEMBERS OF PARTNERSHIP

Original General Partners

2.01 The name and place of residence of each original General Partner is as follows:

Name	Address
Arthur H. Harwood Morris J. Harwood	Branscomb, California 26800 Sherwood Road Willits, CA

Original Limited Partners

2.02 The name and place of residence of each original Limited Partner is as follows:

Name	Address
Arthur H. Harwood	Branscomb, California
Morris J. Harwood	26800 Sherwood Road Willits, CA
Suzanne Harwood Rubattino	1060 Wikiup Drive Santa Rosa, CA
Bank of America, Trustee	10 Santa Rosa Avenue Santa Rosa, CA
Bank of America, Trustee	10 Santa Rosa Avenue Santa Rosa, CA

2.03 Subject to any other

provision of this Agreement, after the formation of the Partnership a person may be admitted as a General Partner with the written consent of all the General Partners and all the Limited Partners, on the recording of an amendment to the original Certificate of Limited Partnership in accordance with the requirements of Section 15525 or Section 25525.5 of the California Corporations Code.

2.04 Subject to any other provision of this Agreement, after the formation of the Partnership a person may be admitted as an additional Limited Partner with the written consent of all General Partners, on the recording of an amendment to the original Certificate of Limited Partnership in accordance with the requirements of Section 15525 or Section 15525.5 of the California Corporations Code.

2.05 Notwithstanding any other provisions of this Agreement, before any person is admitted to this Partnership as a General, additional Limited, or substituted Limited Partner, he shall agree in writing to be bound by all of the provisions of this Agreement.

ARTICLE III
FINANCIAL

3.01 The amount of cash and the description of and the agreed value of the other property contributed by the General and Limited Partners of Harwood Investment Company are set forth in Exhibit "A" attached hereto and incorporated as a part hereof. Exhibit

"A" is the balance sheet as of October 2, 1976 of the said Partnership business. Each General Partner hereof contributes his capital interest in the said Partnership as shown on the said balance sheet except, however, as such interest shall be adjusted for the results of operation and withdrawals of capital and profits prior to the effective date of this agreement. Arthur H. Harwood and Morris J. Harwood each agree to each contribute twenty percent (20%) of his capital interest to the respective trustee of his family trusts.

3.02 In addition to the initial capital contributions of the Partners each Partner may voluntarily make additional contributions to the capital of this Partnership only in such amounts as may from time to time be agreed upon by all the General Partners.

3.03 Limited Partners shall not be required to contribute to the capital of this Partnership or to its creditors any additional money or property, the liability of each Limited Partner being limited to the amount of his initial capital, as set forth in this Agrement.

3.04 No Partner shall receive any interest on his contribution to the Partnership capital, except, however, Suzanne Harwood Rubattino shall be entitled to a payment of $100,000 per year for thirty (30) years, irrespective of Partnership profits, as a guaranteed payment for the use of her capital by the Partnership, which shall be deducted

before computing the net profits or losses of the Partnership.

3.05 No Partner may withdraw any portion of the capital of the Partnership, and no Partner, General or Limited, shall be entitled to the return of his contribution to the capital of the Partnership except on dissolution of the Partnership.

3.06 Subject to the provisions of Paragraph 3.07 of this Agreement, the net profits of the Partnership and any net losses suffered by the Partnership shall be borne by the Partners in the following proportions:

GENERAL PARTNERS

Arthur H. Harwood	17.78 percent
Morris J. Harwood	17.78 percent

LIMITED PARTNERS

Arthur H. Harwood	17.77 percent
Morris J. Harwood	17.77 percent
Suzanne Harwood Rubattino	11.12 percent
Bank of America NT & SA, Trustee of the Arthur H. Harwood 1976 Family Trusts	8.89 percent
Bank of America NT & SA, Trustee of the Morris J. Harwood 1976 Family Trusts	8.89 percent

3.07 No Limited Partner shall be liable or subject to any obligations, losses, debts, or liabilities of the Partnership in excess of the amount in his capital account. Any losses of the Partnership in excess of the amount of the capital of the Partnership shall be borne by the General Partners in the same proportions as they share in the profits of the Partnership.

3.08 At all times the General Partners shall maintain or cause to be maintained true and proper books, records, reports, and accounts in which shall be entered fully and accurately all transactions of the Partnership.

3.09. All books, records, reports, and accounts, together with this Agreement and the Certificate of Limited Partnership and any amendments thereto, shall at all times be kept and maintained at the principal place of business of this Partnership.

3.10 All books, records, reports, and accounts shall be open to inspection by any Partner or his duly authorized representatives, on reasonable notice, at any reasonable time during business hours, for any purpose reasonably relating to his respective interest as a Partner, and said Partner or representative shall have the further right to make copies or excerpts therefrom.

3.11 The Partnership books shall be kept on an accrual basis.

3.12 The fiscal year of the Partnership shall be the calendar year.

3.13 An individual capital account shall be maintained for each General and Limited Partner consisting of his share of the initial capital of the Partnership, any additional contributions to the Partnership, any additional contributions to the Partnership capital made by him pursuant to this Agreement, and any amounts transferred from his income account to his capital account pursuant to this Agreement.

3.14 An individual income account shall be maintained for each General and Limited Partner. At the end of each fiscal year each Partner's share of the net profits or net losses of the Partnership shall be credited or debited to and his withdrawals during such fiscal year deducted from his income account. After such amounts have been credited or debited to and deducted from a Partner's income account, any balance or deficit remaining in such account shall be transferred to or charged against such Partner's capital account; provided, however, that no limited partner may withdraw any portion of his distributive share of the net profits of the Partnership without the consent of all the General Partners.

3.15 Notwithstanding anything to the contrary herein, the Partnership shall distribute to each Limited Partner an amount sufficient to enable each Limited Partner to pay and discharge any tax liability on his share of

undistributed partnership profits and any trustee fee or other reasonable costs incurred by the trustee in administration of the Limited Partnership interests.

ARTICLE IV

RIGHTS, POWERS, DUTIES AND RESTRICTIONS OF PARTNERS

4.01 General Partners shall have full and exclusive charge and control of the management, conduct, and operation of the Partnership in all respects and in all matters.

4.02 General Partners shall devote such time to this Partnership as shall be necessary to conduct this Partnership in an efficient manner.

4.03 All General Partners shall have equal rights in the management and conduct of the Partnership business, except that ARthur H. Harwood shall have the right to execute all deeds and conveyances on behalf of the Partnership.

4.04 Except as otherwise expressly provided in this Agreement, a General Partner shall have all the rights and powers of a Partner in a Partnership without Limited Partners and shall be subject to all the restrictions imposed on General Partners by the Uniform Limited Partnership Act of the State of California or imposed on a Partner in a Partnership without Limited Partners.

4.05 As compensation for his services in and about the Partnership business, each General Partner shall be entitled to such salaries as shall be mutually agreed upon by all of the General Partners which shall be deducted by the Partnership as an ordinary and necessary expense of the Partnership before determination of net profits.

4.07 Notwithstanding any other provision of this Agreement, the Limited Partners are hereby given the right and power to vote on any or all of the following matters which affect the basic structure of the Partnership:

(a) Election or removal of General Partners;
(b) Termination of the Partnership;
(c) Amendment of the Partnership Agreement;
(d) Sale of all or substantially all of the assets of the Partnership.

On such matters each Partner shall have one vote for each percent of Partnership net profits set out in Paragraph 3.06 of this Agreement.

ARTICLE V
TERMINATION OF PARTNERSHIP

5.01 If during the existence of the Partnership one or more General or Limited Partners shall die or be declared incompetent, the remaining Partners agree, subject to the provisions of this Paragraph 5.01 to continue the business of the Partnership

until the end of the quarter in which such event or events occur, and such death or incompetence shall not immediately dissolve the partnership, and the continuing partnership shall be the same partnership for all purposes until the end of said quarter. The quarters are measured in three month increments commencing with January 1, i.e., ending March 31, June 30, September 30 and December 31. It is the intention of the parties that the Partnership shall continue through the then current quarter, and that no decrease in the personnel thereof shall effect a dissolution of the Partnership until the end of said quarter unless the Partnership shall be terminated by majority action as hereinbelow specifically provided.

5.02 Each Partner, General and Limited, agrees for himself and hereby obligates his heirs, executors, administrators and assigns to permit the partnership to use (subject to the terms of this Agreement) his contribution in or to the business for the uses herein specified, until the dissolution of the Partnership.

5.03 In the event of death or incompetence of one or more General or Limited Partners, a majority in interest of the remaining Partners may elect at their option at the end of the quarter in which event or events occur to form a successor partnership and to continue the partnership business, in which event full payment shall be made in cash or in the form of promissory notes by the said successor Partnership within ninety (90)

days for the amount of the book value of the interest of such deceased or incompetent Partner or Partners and for the book value of the interest of any Partner who does not become a Partner in the successor Partnership. Said promissory notes shall be payable in ten equal annual installments with interest at eight percent (8%) per annu. "Book value" for this purpose includes the Partner's capital contribution, his loans (if any) to the Partnership, and his share in an unwithdrawn Partnership profits, adjusted for his share in any undivided Partnership loss, all as set forth in the duly audited Partnership balance sheet at the end of the fiscal year in question. In the determination of said book value no allowance shall be made or included for "goodwill."

5.04 If any General or Limited Partner shall withdraw or be adjudicated a bankrupt during the existence of the Partnership, the remaining partners shall have the same rights and duties as if the withdrawing or bankrupt Partner had died upon such date, except that any successor Partnership may, at its election, pay the book value of the interest of the said withdrawing or bankrupt Partner in three equal annual installments, without interest, the first such installment to be due on the ninetieth (90th) day after the end of the quarter in which such event shall occur.

5.05 The Partnership may, however, be dissolved at any time by a majority in interest of all Partners, in which event they shall give written

notice to the other Partners of their election to dissolve by addressing the same to each Partner at his last known address according to the Partnership records, and depositing the same in the United States mail, postage prepaid. The notice shall specify the date fixed for the dissolution of the Partnership, and upon such date the Partnership shall be dissolved and liquidated and the assets thereof distributed in the manner provided herein below.

5.06 In the event of dissolution of the Partnership and complete liquidation of all of the Partnership assets, all of the partners, General and Limited, shall share in the profits and losses realized in the liquidation process in the same proportions as set forth in Paragraph 3.06 above, and there shall be no preference upon such final liquidation as between General and Limited Partners, except that the liability of the Limited Partner for Partnership obligations shall be limited as set forth in Paragraph 3.07.

5.07 Upon complete liquidation of the Partnership assets, funds thus realized shall be first applied to pay Partnership debts, and any excess shall be distributed among the Partners in accordance with their respective entitlements. In the event that installment distributions are made, no Partner shall receive any installment distributions large enough to reduce his investment in the Partnership below an amount at least equal to his share of any possible loss.

5.08 Notwithstanding any other provision of this Agreement if Arthur H. Harwood and Morris J. Harwood predecease Suzanne Harwood Rubattino she shall have the right and option to sell her full interest in the Partnership to the Partners of any successor Partnership formed pursuant to this Agreement at an amount equal to the fair market value of her Partnership interest. Said value shall be determined by an appraiser to be selected with the mutual consent of Suzanne Harwood Rubattino and a majority of the successor Partners. In determining fair market value the appraiser shall value all assets of the Partnership including lands, timber, and investments at their fair cash market value, except however no allowance shall be made or included for "goodwill".

ARTICLE VI

MISCELLANEOUS CLAUSES AND REPRESENTATIONS

6.03 All questions with respect to the construction of this Agreement and the rights and liabilites of the parties hereto shall be governed by the laws of the State of California.

6.04 Subject to the restrictions against assignment as herein contained, this Agreement shall insure to the benefit of and shall be binding upon the assigns, successors in interest, personal represetatives, estates, heirs, and legatees of each of the parties hereto.

6.06 This Agreement contains

the entire understanding among the Partners and supersedes any prior written or oral agreements between them respecting the subject matter contained herein. There are no representations, agreements, or understandins, oral or written, between and among the Partners relating to the subject matter of this Agreement which are not fully expressed herein.

6.07 This Agreement is subject to amendment only with the unanimous consent of all of the Partners.

On December 29, 1976, Bud and Virginia gave an 8.89 percent limited partnership interest in HIC to Bank of America NT & SA, trustee for the Arthur H. Harwood 1976 family trust for the benefit of their children.

On December 29, 1976, Jack gave an 8.89 percent limited partnership interest in HIC to Bank of America NT & SA, trustee for the Morris J. Harwood 1976 family trust for the benefit of his children. Margaret consented to have the gift made one-half by each of Morris and Margaret.

In 1973, HIC applied for a loan from the Federal Land Bank. Submitted with the loan appplication were balance sheets as of December 31, 1972, for Belva, Jack, Bud, and Virginia. Belva's interest in HIC was shown as having a book value of $603,846 and an appraised value of $2,622,196. The one-third interest in HIC of Jack was shown as having a book value of $544,271 and appraised values of $2,562,620. The one-third interst in HIC of Bud and Virginia was shown as having a book value of $546,783 and an appraised value of $2,565,133.

In August 1976, an attorney representing HIC asked Robert E. Kleiner, a professional appraiser, who had previously done work for HIC and was familiar with some of its property, to prepare a report appraising HIC, such

appraisal to be used by HIC legal and accounting personnel in connection with the conveyance by gift of interest in HIC. Kleiner prepared report as requested, with the assistance of Raymond E. Granvall, Jr. HIC personnel assisted Kleiner and Granvall by providing information they needed to prepare their appraisal. The report was completed on September 3, 1977, and appraised the December 31, 1976 net asset value of HIC at $20,550,000.

Beginning in the late 1960's, HIC, through Bud and others, began bidding on forest service contracts. These contracts represented the right to harvest timber at some specified future date, typically four or five years after the date of acquisition of the contract. During the middle 1970's, including 1976 and 1977, HIC bid far

more for forest service contracts than the spot price for comparable timber at the time of the bids. Bud was willing to bid in this manner because he expected timber prices to rise between the time of the bid and the time the timber would be harvested.

After concessions, respondent contends that the value of the interest in HIC that Belva gave to Jack and Bud on January 1, 1973, was $904,341.67; that the value of the interest in HIC that Jack, Bud and Virginia gave to Suzanne on January 1, 1973, was $301,386.94; and that the value of the 8.89 percent limited partnership interests that Bud and Virginia and Jack and Margaret gave on December 29, 1976, to trusts for the benefit of their respective children was $1,278,826.50. Respondent also contends that no

consideration was paid by Suzanne in exchange for the interest in HIC she received on January 2, 1973, and that restrictive clauses in the various HIC partnership agreements, and savings clauses in the Harwood family trust agreements, have no effect on the gift tax deficiency he determined.

OPINION

Issue I

Section 2501 imposes a tax on the transfer of property by gift by any individual. Section 2512(b) provides that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." The regulations further provide that:

[t]ransfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. *** [Section 25.2512-8, Gift Tax Regs.]

The Supreme Court has interpreted these provisions as follows (Commissioner v. Wemyss, 324 U.S. 303, 306-307 (1945):

Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent" it formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, deemed a fit * * *". And Treasury Regulations have emphasized that common law considerations were not

embodied in the gift tax.

To reinforce the evident desire of Congress to his all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arms length, and free from any donative intent)." Treas. Reg. 79 (1936 ed.) Art. 8. Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an adequate and full consideration in money or money's worth". [Fn. ref. omitted.]

Petitioners contend, and respondent denies, that the January 1, 1973 transaction wherein Belva transferred her one-sixth interest in HIC to Bud and Jack in exchange for a promissory note was a transfer in the ordinary course of business and hence was not subject to the gift tax, even if the value of her

interest in HIC exceeded the value of the note she received therefor.

Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift. Estate of Reynolds v. Commissioner, 55 T.C. 172, 201 (1970). We do not believe that a transfer by a mother to her sons of her interest in the family partnership, structured totally by the family accountant, with no arm's-length bargaining, can be characterized as a transaction in the ordinary course of business. We hold that Belva made a gift to Bud and Jack in the amount that the value of the one-sixth interest in HIC which was transferred to them exceeded the value of the note she received therefor.

Issue 2

As noted in the discussion under Issue 1, where property is transferred for less than an adequate consideration, the amount by which the value of the property transferred exceeds the value of the consideration received therefor is a taxable gift, unless it can be established that the transfer occurred in the ordinary course of business. Petitioners content that the January 1, 1973 transaction wherein Jack gave up a one-thirty sixth interest in HIC, Bud and Virginia each gave up a one-seventy second interest in HIC and Suzanne gained a one-eighteenth interest in HIC was a transfer of property made in the ordinary course of busines, and, in the alternative, if that transaction constituted gifts from Jack, Bud and Virginia to Suzanne, that the $300,000

payment made to HIC by Suzanne in 1978 should be recognized as consideration for the one-eighteenth interest she received on January 1, 1973, and should reduce accordingly the amount of the gifts made on that day. Respondent denies both these contentions.

Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift. Estate of Reynolds, supra, 55 T.C. at 201.

We do not believe that the intra-family adjustment in interests in the family partnership here in issue, which was structured completely by the family accountant, with no arm's-length bargaining, can be characterized as a transfer made in the ordinary course of business. We note that the January 1, 1973 partnership agreement states that

only Bud and Jack are to have management responsibilities, which makes clear that this transaction was not designed to acquire Suzanne's services for the partnership. We hold that Bud and Virginia, and Jack, made taxable gifts to Suzanne in 1973 in the amount that the fair market value of the interests in HIC transferred to Suzanne exceeded the value of any consideration received therefor.

We must next determine whether $300,000 Suzanne paid to HIC on October 19, 1978 constitutes consideration for the one-eighteenth partnership interest she received on January 1, 1973. Petitioners bear the burden of proof on this issue. Rule 142(a).

No note or other evidence of indebtedness was created in 1973 when Suzanne received her additional

one-eighteenth interest in HIC. In 1978, one of respondent's agents pointed out to Convery that no payment had ever been received by HIC in connection with Suzanne's acquisition of an interest therein. Subsequently, Suzanne paid $300,000 to HIC. Suzanne was not called to testify concerning the nature of this payment, although she was available to testify. No direct evidence was put in the record connecting this payment to the January 1, 1973 transaction. Under these circumstances, we cannot say that petitioners have met their burden of proving that the $300,000 payment in question was consideration paid in exchange for the one-eighteenth partnership interest acquired by Suzanne on January 1, 1973.

Petitioners do not contend that any other consideration was paid to HIC or

to Bud, Virginia or Jack in exchange for the one-eighteenth interest transferred to Suzanne on January 1, 1973. We threfore hold that Bud and Virginia each made a gift equal to the full value of a one-seventy second interest in HIC and that Jack made a gift equal to the full value of a one-thirty sixth interest in HIC as of January 1, 1973.

Issue 3

Restrictive provisions in a partnership agreement which limit the amount received from the partnership by a withdrawing partner or the estate of a deceased partner to the book value of his partnership interest are not binding upon respondent for gift tax purposes. Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946); James v. Commissioner, 3 T.C. 1260 (1944), affd. 148 F.2d 236

(2d Cir. 1945); Berzon v. Commissioner, 63 T.C. 601, 612-613 (1975), affd. 534 F.2d 528 (2d Cir. 1976). Such an agreement is a factor affecting value which may be considered along with other factors in determining value. James v. Commissioner, supra; Sptizer v. Commissioner, supra; Berzon v. Commissioner, supra. Petitioners contend that the aforementioned cases should no longer be followed insofar as they hold that restrictive clauses in partnership agreements are not binding upon respondent for gift tax purposes, and, in the alternative that the restrictive provisions in the January 1, 1973 and December 29, 1976 HIC partnership agreements depressed the value of interests in HIC to their book value.

From January 1, 1955 to December

31, 1972, HIC was operated under a partnership agreement dated January 1, 1955. On January 1, 1973, a new partnership agreement was adopted, which was itself replaced by an agreement dated December 29, 1976. Each of these agreements contains provisions to the effect that if a partner died or became incompetent, the remaining partners could continue the partnership business by paying book value for the dead or incompetent partner's interest, and that if a partner withdrew or was adjudicated a bankrupt, the remaining partners would have the same rights as if the partner died and, in addition, the partnership itself could elect to buy out the partner at book value. According to petitioners, this provision was inserted in each of the HIC partnership agreements for the business purpose of

preventing disputes in the event a partner died or wished to withdraw from the partnership. Petitioners contend that "[i]n view of the fact of the existence of the strong business motive, the Court should hold that the agreements fixed the value at book."

> It has been the consistent view of this Court in cases where the stockholder is under no obligation to sell by reason of his contract, but has simply agreed to offer his stock to others on certain stated terms if he should desire to sell, that such an agreement does not have the effect of limiting the value upon which the Government may compute its tax to the amount at which the stock is to be offered if the owner decides to sell. * * * [James v. Commissioner, 3 T.C. at 1264.

As we have pointed out, "[o]ne rationale for rejecting the formula price as the absolute determinative of fair market value is that such a figure does not represent the value of all the rights inherent in * * *ownership * * *." Estate of Reynolds v. Commissioner,

55 T.C. 172, 190 (1970).

The interests the transfer of which gave rise to the present controversy carried with them rights additional to the rights of their holders to receive certain payments upon withdrawal from HIC. The fact that restrictive provisions were put in the HIC partnership agreements for business reasons is irrelevant to the question before us, since the reasons for the adoption of the restrictive provisions have no effect on the various rights, other than those derived from the restrictive provisions, that were inherent in interests in HIC.

Respondent concedes that the restrictive provisions are a factor to be considered in determining the value of partnership interests in HIC. The parties disagreee as to the magnitude of

the impact upon value of that factor.

Petitioners first argue that a gift by a partner of part of his interest in HIC would be a partial withdrawal under the restrictive clauses of the partnership agreements, so that HIC would have the right to purchase the donated interest from the donee at book value. This contention does not withstand close scrutiny.

If a gift of part of a partner's interest constituted a withdrawal with respect to that partial interest, then a fortiori a sale of part of a partner's interest would constitute a withdrawal, giving HIC the right to purchase that interest from its buyer at book value. This interpretation of the various HIC partnership agreements strikes us as bizarre, particularly in light of the fact that it would have been easy to

require partners wishing to sell or to give away portions of their interest in HIC to first offer those interest to HIC at book value. In the absence of a provision for such a right of first refusal, and considering that petitioners failed cite a single authority in support of their interpretation of the restrictive clauses, we cannot accept the argument that any prospective purchaser of an interest in HIC would have been concerned that HIC could, immediately following a purchase of such an interest, force the purchaser to sell his interest at book value.

Petitioners also rely on the report and testimony of William Haynes, an expert witness, to establish the effect of the HIC partnership agreement's restrictive provisions on the value of

an interest in HIC. Haynes suggested that a potential purchaser of a minority interest in HIC would require a risk premium based upon HIC's small size and the cyclical nature of its business. Such a risk premium is irrelevant to the issue of the impact upon value of the restrictive provisions.

Haynes next determined that a lack of marketability discount of 25 percent was appropriate, on the grounds that a person acquiring an interest in HIC "may not ever be able to get out any more than the book value, so there would be a lack of marketability of this partnership interest, due in part [to] the restrictive provisions, * * * and also due to the * * * well known fact that partnership interest are highly illiquid anyway."

Haynes' proposed lack of

marketability discount is founded both on the restrictive provisions of the HIC partnership agreements and on the general illiquidity of partnership interests. Since we are here considering only the effect of the restrictive provisions on the value of interests in HIC, we cannot accept the full 25-percent discount suggested by Haynes.

The interest in HIC Transferred to the Harwood family trusts in 1976 were both held in trust. It is, of course, unlikely that the trusts will ever die or be adjudicated incompetent or bankrupt. The trusts thus insulate their beneficiaries against the HIC restrictive agreements. Presumably a prospective purchaser of any of the interests in HIC here being valued could have elected to take title to such

interest through a trust, and thus avoid to some extent the effect of the restrictive clauses.

We believe that the restrictive clauses did have a depressing effect on value. See Moore v. Commissioner, 3 T.C. 1205, 1211 (1944); Berzon v. Commissioner, supra 63 T.C. at 612-613 (1975); Kline v. Commissioner, 44 B.T.A. 1052, 1056 (1941), affd. 130 F.2d 742 (3d Cir. 1942), cert. denied 317 U.S. 697 (1942). We find and hold that the restrictive clauses in the HIC partnership agreements of January 1, 1973 and December 29, 1976, negatively affected the value of minority interests in HIC and must be taken into account in valuing the gifts in issue.

Issue 4. Valuation of the 1976 Gifts of Interests in HIC

Care should be taken to arrive at an accurate valuation of any interest in

a business which the donor transfers without an adequate and full consideration in money or money's worth. The fair market value of any interest in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. The net value is determined on the basis of all relevant factors including --

(1) A fair appraisal as of the date of the gift of all the assets of the business, tangible and intangible, including good will;

(2) The demonstrated earning capacity of the business; and

(3) The other facts set forth in paragraph (f) of section 25.2512-2 relating to the valuation of corporate stock, to the extent applicable. [Sec. 25.2512-3(a), Gift Tax Regs.]

(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. * * * [Sec. 25.2512-2(f), Gift Tax Regs.]

Bud and Virginia, and Jack, respectively, made gifts of 8.99 percent limited partnership interests in HIC on December 29, 1976. The parties disagree as to the December 29, 1976 value of those gifts. Each party relies on the reports and testimony of its expert witnesses.

Petitioners contend that we should

accept the valuation prepared by their expert, Charles Stark, using a capitalization of income method.

Stark appraised an 8.9 percent limited partnership interest in HIC as of December 29, 1976, and 16.7 percent and 2.8 percent partnership interests in HIC as of January 1, 1973. He determined the average income of HIC for the five-year period prior to January 1, 1973, and for the four year period prior to December 29, 1976, and capitalized the resulting average yearly incomes using a capitalization rate of five. He then allowed a 35 percent discount for illiquidity and lack of control.

Stark's appraisal is accurate only if prospective buyers would value the interests in question by capitalizing past earnings of HIC as suggested by Stark. We are not persuaded that in an

industry as cyclical as the forest products industry (petitioners repeatedly stressed the cyclical nature of HIC's business) average past earnings of HIC would be of overriding interest to a prospective purchaser. HIC's future earnings depended on the future price it could get for its timber assets, which can hardly be predicted by looking at average past earnings for five or four-year periods. We note that in 1976 Bud expected timber prices to rise, as evidenced by his willingness to bid substantially more than the spot price for forest service contracts for future access to timber. Additionally, we are not satisfied that Stark has adequately supported his capitalization rate of five. A small change in this rate would have a major effect on the appraised value. We therefore decline

to accept Stark's capitalization of income approach to valuing interests in HIC in either 1973 or 1976.

We find additional support for refusing to rely on a capitalization of income approach in that HIC's business consisted solely of acquiring timber for the use of its affiliated companies. HIC's value was thus directly tied to the value and expected future value of its timber holdings, and potential purchasers would most likely be more interested in HIC's net asset value than its past earnings. See Estate of Andrews v. Commissioner, 79 T.C. 938, 944 (1982); Estate of Heckscher v. Commissioner, 63. T.C. 485, 493 (1975).

Respondent relies primarily upon a report estimating the December 31, 1976, net asset value of HIC, prepared by Robert E. Kleiner and Raymond E. Granvall, Jr., which was completed

industry as cyclical as the forest products industry (petitioners repeatedly stressed the cyclical nature of HIC's business) average past earnings of HIC would be of overriding interest to a prospective purchaser. HIC's future earnings depended on the future price it could get for its timber assets, which can hardly be predicted by looking at average past earnings for five or four-year periods. We note that in 1976 Bud expected timber prices to rise, as evidenced by his willingness to bid substantially more than the spot price for forest service contracts for future access to timber. Additionally, we are not satisfied that Stark has adequately supported his capitalization rate of five. A small change in this rate would have a major effect on the appraised value. We therefore decline to accept

this record. We therefore reaffirm our ruling at trial that the report is admissible.

The Kleiner-Granvall report contains three sections. The first section values the HIC timber properties. Each such property is discussed and valued separately, as to land value, timber value, and value of improvements, if any. Relying on a comparable sales method, the report values the various timber holdings of HIC at $28,200,000.

The second part of the Kleiner-Granvall report values the plant property of HIC, that is, two sawmills and various related machinery. Using both a cost approach and a comparable sales approach, the report values the plant property at $1,700,000.

The third section of the Kliener-Granvall report considers other

assets of HIC, primarily current assets and amounts due from affiliates, and liabilities of HIC. The report finds total other assets of $5,611,697 and total liabilities of $14,967,792. By summing the aforementioned values, Kleiner and Granvall arrive at a total net asset value (approximate) of $20,550,000.

Petitioners engaged Paul R. Kevin, Jr., to appraise the net asset value of HIC as of January 1, 1973, and December 29, 1976. In his appraisal of the December 29, 1976 net asset value, Kevin assumed that 101,169,000 board feet of timber, out of HIC's total timber holdings of 252,000,000 board feet, should be valued as part of the land value, rather than as stumpage. Kevin allowed a value of $150 per acre for the value of such timber.

In valuing an additional 82,700,000

board feet of HIC's timber, Kevin assumed that only 10,000,000 board feet of such timber would be cut per year for 25 years, and arrive at a valuation for this timber by reducing to present value, after an allowance for inflation, the sum of the proceeds from 25 years of cutting 10,000,000 board feet per year. After a careful study of the record, we are not satisfied that Kevin has adequately supported either of these assumptions. We believe that the Kleiner-Granvall report, which was based on a comparable sales analysis of the value of all of HIC's timber, and so makes neither of the aforementioned assumptions, provides a more reliable estimate of HIC's net asset value as of late 1976.

On the basis of the foregoing, and the entire record, we find and hold that the net asset value of HIC on December

31, 1976, was $20,550,000. This finding does not end the matter before us, for we must still determine what, if any, discounts apply in valuing 8.89 percent limited partnership interests in HIC.

Petitioners, relying on the testimony and report of Stark, contend that the stock of publicly traded forest profucts companies traded during 1976 at an average 60-percent discount from their net asset values. Respondent's expert Edward Bard allowed a 30-percent discount from net asset value in valuing minority interests in HIC. Bard derived this discount from a study which found that nondiversified closed-end investment companies traded at an average 26.4 percent discount from their net asset values. We believe that these two discounts from net asset value reflect the fact that minority shareholders in a forest products

corporation or a closed-end investment company have no right to receive their pro-rata share of net asset value. We agree that the limited partnership interests in HIC may be analogized to a stock interest in a forest products company or closed-end investment company in this respect, and that a discount to reflect this fact is appropriate. However, the data relied upon by Stark in reaching his proposed discount of 60 percent is unfortunately incomplete, and we do not believe that he adequately substantiated his suggested 60-percent discount.

The stock of publicly traded forest products companies and closed-end investment companies is traded on public markets and is therefore readily marketable. Limited partnership interests in HIC were nor regularly traded on any market, and thus represent

relatively illiquid investments. We believe that an additional discount must be allowed to reflect the lack of marketability of limited partnership interests in HIC.

Stark suggested that a lack of marketability discount of between 20 percent and 50 percent is appropriate, and chose to apply a discount of 35 percent. Again, he failed to adequately substantiate the discount he chose to apply.

We have found that on December 31, 1976, HIC had a net asset value of $20,500,000. Neither party contends that any significant change in net asset value occurred between December 29, 1976 and December 31, 1976, and we therefore accept $20,550,000 as HIC's net asset value on the valuation date. Of this sum, $1,826,895 is the pro-rata share of an 8.89 percent interest in HIC.

Doing the best that we can with the record before us, we find and hold that this maount must be discounted by 50 percent to reflect the fact that the interests in HIC being valued were minority interests, were not publicly traded, and were subject to the restrictive clause in the HIC partnership agreement (see our discussion in Issue 3 above). We thus find that the December 29, 1976 value of an 8.89 percent limited partnership interest in HIC is $913,447.50.

Issue 5. Valuation of the 1973 Gifts of Interests in HIC

On January 1, 1973, Belva transferred to Jack and Bud a one-sixth interest in HIC in exchange for a promissory note in the amount of $573,365. On that same date, Bud and Virginia, and Jack, respectively,

transferred to Suzanne one-thirty sixth partnership interest in HIC. THe parties disagree as to the January 1, 1973 value of these partnership interests. Each party relies on the reports and testimony of its expert witnesses.

Balance sheets submitted by Belva, Jack, Bud, and Virginia, in connection with an application by HIC for a loan from the Federal Land Bank, show HIC as having a net asset value of $7,749,950 on December 31, 1972. Respondent contends that the net asset value for HIc reflected on these loan applications is correct, but concedes that 30 percent discount for "lack of marketability" and "minority interest" is appropriate in valuing the interests at issue.

Petitioners' expert Kevin concluded that HIC had a net asset value of $7,505,000 on January 1, 1973. We

Suzanne. Discounting these amounts by 50 percent gives values for purposes of the gift tax of $625,416.67 for a one-sixth interest,[20] and $208,472.22 for a one-eighteenth interest.[21]

Issue 6. Are the Savings Clauses in the Harwood Trust Agreements Enforceable

On December 29, 1976, Jack and Margaret Harwood and Bud and Virginia Harwood each created a trust for the benefit of their respective children, with the Bank of America acting as trustee for each trust. Each trust received from its grantors and 8.89 percent limited partnership interest in HJC. The trust agreements contained the following clause:

> Article FIRST. Property subject to this instrument listed in Schedule "A" is referred to as the "trust estate" and shall be held, administered, and distributed in accordance with this instrument. In the event that the value of the partnership

to exceed $400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower is not reasonably defendable, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and $400,000. The note shall carry interest and be effective as of the day of the gift. [Emphasis supplied.]

Petitioners contend, relying on King v. United States, 545 F.2d 700 (10th Cir. 1976), that the savings clause in each trust agreement effectively avoids any gift tax upon the transfer of property to the trusts to the extent that the value of such property exceeds $400,000 per trust. Respondent takes the opposite position, relying on Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied 323 U.S. 756 (1944).

In King, supra, the taxpayer created trusts for the benefit of his four children, with his lawyer as

trustee. He then sold stock in his closely held corporation to the trusts, retaining the stock as security for payment of the purchase price, and the four trusts executed notes for $2,000,000 based upon a per share price of $1.25. Letter agreements were drawn up, providing that (545 F.2d at 703-704):

> if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service. (Emphasis supplied)

The Colorado Corporation was subsequently adjudicated bankrupt.

The Internal Revenue Service determined that Colorado Corporation stock was worth $16 per share at the date of transfer, and assessed a gift tax on the value of the stock in excess of the face value of the notes. It does

not appear that any adjustment of the purchase price was made by the trust.

The Tenth Circuit reasoned that the clause in the letter set out above indicated that the parties in good faith meant the transferred stock to be priced at market value (545 F.2d at 706):

> The IRS contention that the price adjustment clause violates public policy in that it deters administrative enforcement of the gift tax provisions is valid only if the transaction be construed as an inter vivos transfer undertaken to reduce King's estate. The IRS argument would be applicable if we were to hold that the trial court's finding that King intended that the trust pay full and adequate consideration predicated upon the price-adjustment proviso is clearly erroneous. It is not. Under the facts found, King is not subject to the gift tax under Treas. Reg. sec. 25.2512-8 because the transaction was made in the ordinary course of business at arm's length, free from any donative intent. We hold that the trial court did not err in holding that the aforesaid stock transfers are not subject to a gift tax. (Emphasis supplied)

The Tenth Circuit also stated that the gift tax was designed to prevent

taxpayers from using gifts to reduce their taxable estates, and, evidently concluded that since The Colorado Corporation had been adjudicated bankrupt, the taxpayer's estate was in no way reduced by the earlier transfer of shares of Colorado Corporation stock to the trusts.

Procter, supra, also involved a gift to a trust. The trust agreement of the donee trust contained a clause which provided (142 F.2d at 827):

"Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created." (Emphasis supplied)

The taxpayer argues that this clause rendered the gift in question ineffective to the extent that it gave rise to a gift tax.

The Fourth Circuit rejected this argument (142 F.2d 827-828):

> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.
>
> The condition is contrary to public policy for three reasons: In the first place, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to

enforce the tax would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court. Cf. Lord v. Veazie, 8 How. 251, 12 L.Ed. 1067; Van Horn v. Kittitas County, C.C., 112 F. 1. As was well said by Chief Justice Taney in Lord v. Veazie, supra (8 How. 255, 12 L.Ed. 1067):

"It is theoffice of courts of justice to decide the rights of persons and of property, when the persons interested cannot adjust them by agreement between themselves, and to do this upon the full hearing of both parties. And any attempt, by a mere colorable dispute, to obtain the opinion of the court upon a question of law which a party desires to know for his own interest or his own purposes, when there is no real and substantial controversy between those who appear as adverse parties to the suit, is an abuse which courts of justice have always reprehended, and treated as a punishable contempt of court."

In the third place the condition is to the effect that the final judgment of a court is to be helf for naught because of the provision of an indenture necessarily before the court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax. 28 U.S.C.A. sec. 400; Wilson v. Wilson, 4 Cir., 141 F.2d 599. The only way, therefore, in which it could be determined by "final judgment" of a federal court of last resort that any part of a transfer was subject to a gift tax would be for a tax to be assessed by the Commissioner and upheld by such court in the course of legal proceedings instituted for its enforcement or for its recovery after payment. This final judgment would fix the liability of the donor for the tax; and only then could the condition become operative. The condition, however, could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment. To state the matter differently, the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment.

We do not believe that the savings clause here under consideration falls within the ambit of Procter. The clause

in issue provides that if the value of the gifts of interests in HIC are "finally determined to exceed $400,000 for purposes of computing the * * * United States Gift Tax, and in the opinion of the Attorney for the turstee a lower value is not reasonably defendanble," the trustees shall execute notes to the respective grantors for any value in excess of $400,000. Procter is opposite only if we read the words "finally determined" to refer to a final judgment by a court of competent jurisdiction. Such an interpretation, however, would render a nullity the succeeding phrase "and in the opinion of the Attorney for the trustee a lower value is not reasonably defendable," since it would be absurd for the trustee to defend a lower value after a final judgment had been rendered.

We believe the more reasonable

interpretation of the clause at issue is to read "finally determined" to mean either eventually determined by appraisers or "determined by the IRS." Thus, if an appraisal of HIC or, alternatively, an IRS determination was received by the trustess which valued the donated interests at more than $400,000 each, and the trustees accepted such appraisal, the trustees were to execute promissory notes to the trust grantors in an amount sufficient to insure that no more than $400,000 worth of property was given to each trust.

On this reading of the savings clause, the trustee has no power to issue notes to the grantors upon a determination by a court that the value of property transferred to the trustee exceeded $400,000. We are thus not presented with the question whetner a savings clause similar to that

considered in Procter can serve to avoid gift tax on a transfer that is otherwise a taxable gift.

King, supra, is also distinguishable from the instant case. Whether we read the savings clause as allowing the trustees of the Harwood family trusts to issue promissory notes to the trustors in the event that the IRS determined the value of the 8.89 percent limited partnership interests in HIC exceeded $400,000 each, or upon receipt of an appraisers report, the fact remains that the trustees did not issue such notes. No notes were issued in King either, but there issuing notes would have been an empty formality, since the trust corpus-shares in the bankrupt Colorado Corporation was worthless by the time of trial. The Tenth Circuit in King evidently relied on this fact in reaching its holding on

this issue:

> Significantly, [sic] we believe, is the fact that perhaps the main purpose of the gift tax was to prevent or conpensate for the avoidance of death taxes by taxing the gifts of property inter vivos which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death. Sanford's Estate v. Commissioner, 308 U.S. 39, 60 S.Ct. 51, 84 L.Ed. 20 (1939). No such risk is involved in the instant case. 545 F.2d at 706.

In the instant case we have found that the interests in HIC held by the Harwood family trusts were worth substantially in excess of $400,000.

The trustees were aware (we assume) of the Kleiner report, and the IRS's gift tax determination, but they evidently believed that a value lower than the appraised value and the value determined by the IRS was defensible, and did not issue promissory notes to the trust grantors. There, we believe, the matter ends, since we do not believe the savings clause in issue requires (or

entitles) the trustees to issue promissory notes to the trust grantors in the event of a court judgment finding a value above $400,000 for the limited partnership interests given to the trusts.

We hold that the savngs clause in the Morris J. Harwood 1976 family trust and the Arthur H. Harwood 1976 family trust has no effect on the amount of the gifts we have otherwise determined were made to the trusts by petitioners herein.

Filed March 18, 1986

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

VIRGINIA Z. HARWOOD, et al.,	)C.A. Nos.
	)85-7091,
Petitioners-Appellants,	)85-7092,
	)85-7093,
	)85-7094
vs.	)
	)Tax Court
COMMISSIONER OF INTERNAL REVENUE	)Nos.
	)6557-81,
	)6559-81,
Respondent-Appellee.	)6560-81,
	)6561-81
	)
	)MEMORANDUM
	)

On Appeal From the United States Tax Court for the Northern District of California Petition to Review a Decision of the Tax Court of the United States

Argued and Submitted February 12,1986
San Francisco, Calfornia

Before: BROWNING, Chief Judge, TANG and BEEZER, Circuit Judges

In these consolidated appeals, four taxpayers appeal the Tax Court's confirmation of gift tax deficiencies for

intra-family transfers of minority interest in a family owned partnership. In the 1973 tansaction, taxpayers' sister gained 1/18th interest in the family partnership. The Tax Court held that this was a gift rather than a transfer in the ordinary course of business because the donors' interests in that partnership were correspondingly reduced, the donee gave no consideration at the time of the transfer, and donee did not sign a document promising to pay for the interest. Also, the court noted the donee's close relationship to donors.

Petitioners also challenge the Tax Court's valuation of the interests transferred in 1973 and 1976.[2]

---

*This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 21.

[1] Tax Court decision reported at 82 T.C. 239 (1984).

Specifically, petitioners argue that the court's valuations are not supported by substantial evidence and the court abused its discretion in admitting a valuation study done at the Harwoods' expense and request. We affirm.

FACTS

Harwood Investment Company ("HIC") was founded in 1955 by Arthur Harwood Sr., father of Morris ("Jack") and Arthur Jr. ("Bud"). HIC is a California limited partnership owned by the Harwood family that buys and manages land and timber. It owns plants and machinery in Branscomb and Willits, California. HIC deals with other Harwood family partnerships. Harwood Logging Company ("HLC") buys timber from HIC and cuts it into logs.

---

2 Petitioners concede that transfer of the interests in 1976 constitute gifts.

HIC also leases facilities and equipment to Harwood Products ("HP"), which is the successor of "Branscomb Enterprises," a logging company founded by Bud and Jack's father, Arthur Harwood Sr., in 1953.

In 1973, Jack and Bud, who are brothers, and Bud's wife Virginia, transferred 1/18th interest in Harwood Investment Company ("HIC"), to Suzanne, sister to Bud and Jack. After the 1973 transaction, Jack's interest was reduced by 1/36th and Bud and Virginia's interests were each reduced by 1/72nd. The Commissioner treated the transfer as a gift and assessed gift tax deficiencies of $91,988 against Jack and $40,787 each against Virginia and Bud. In 1976, Bud and Virginia transferred a 8.89 percent limited partnership interest to the "Arthur M. Harwood 1976 Family Trust.[3]

[3]HIC was restructed as a limited partnership in 1976.

They concede gift tax liability for this transfer but challenge the valuation of the interest transferred. Jack and his wife Margaret, made an identical transfer of 8.89 percent limited partnership interest in HIC to a trust for their children. They too admit gift tax liability but disagree with the amount.[4]

1973 Transfer to Suzanne

The Tax Court's findings of fact are reversed only if clearly erroneous but the court's conclusions of law are reviewed de novo. Kalgaard v. Commissioner, 764 F.2d 1322, 1323 (9th Cir. 1985); Nunley v. Commissioner, 758

---

[4]For the 1976 transfers, the Tax Court confirmed deficiencies of $209,786 against Virginia, $209,786 against Bud, and $189,558 against Margaret. Gift tax of $91,888 was assessed against Jack for the quarter ending 3/31/73; $221,848 for the quarter ending 12/31/76; $12,240 for the quarter ending 12/31/78, and $16,210 for the quarter ending 12/31/79.

F.2d 372, 373 (9th Cir. 1985); Estate of Shafer v. Commissioner, 749 F.2d 1215,1218 (6th Cir. 1984). Petitioners contend that the January 1, 1973 transaction in which Suzanne received an additional 1/18th interest in HIC was a transfer in the ordinary course of business. In the alternative, petitioners argue that if the transaction was a gift to Suzanne, the $300,000 transfer made by Suzanne to HIC in 1978 constitutes consideration for the interest. They cite the testimony of Convery, the Harwood family attorney who structured the transaction, that it was not intended as a gift and that Suzanne's capital account in HIC was increased in 1973 to reflect the transaction.

Convery also testified that the $300,000 which Suzanne paid to HIC in 1978 after an IRS auditor called

attention to the fact that she had not paid for her interest, was payment for that interest and was so noted on HIC's books. Also, Convery submitted a summary which he prepared that attested to this same information.

I.R.C. §2501 provides that "[w]here property is transferred in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." The gift tax is not confined to exchanges that fall within the common law concept of gifts, but "embrace[s] as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore." Section 25.2512-8, Gift Tax Regs.

Even when property is transferred for less than full consideration the transaction may escape gift tax treatment if it qualifies as having been made "in the ordinary course of business.[5] Only a transaction which is bona fide, at arm's length, and free from any donative intent, is in the ordinary course of business. Commissioner v Wemyss, 324 U.S. 303, 306-07 (1945).[6] Transactions between family members are subject to special scrutiny and are presumed to be gifts. Estate of Reynolds v Commissioner, 55 T.C. 172, 201 (1970).

---

[5]"Bad bargains, sales for less than market, sales for less than adequate consideration in money or money's worth are made every day in the business world, for one reason or another; but no one would think for a moment that any gift is involved, even in the broadest possible sense of the term 'gift.'" Estate of Monroe D. Anderson, 8 T.C. 706, 720 (1947).

First, the Tax Court held that the transfer was not in the ordinary course of business and therefore the value transferred over the consideration paid was subject to gift tax. "We do not believe that the intra-family adjustment of interests in the family partnership here in issue, which was structured completely by the family accountant, with no arm's-length bargaining, can be characterized as transfer made in the ordinary course of business.[7]

Next, the Tax Court held that Suzanne gave no consideration for the interest. The court found that no note or other evidence of indebtedness was created in 1973. Suzanne did not transfer the money to HIC until after an IRS agent commented on her failure to

---

[7]Harwood v. Commissioner, 82 T.C. at 259.

give consideration. Suzanne did not testify concerning the nature of the payment. Petitioners do not contend that any other consideration was paid to HIC. Petitioners, therefore, failed to establish that the $300,000 was consideration for the interest. Consequently, the entire value was subject to gift tax. The Tax Court's finding that the transfer was a gift is based on substantial evidence and is not clearly erroneous.

EFFECT OF RESTRICTIVE PROVISIONS

Petitioners contend that the book value of the interests, as calculated under the restrictive provisions in the 1973 and 1976 partnership agreements, conclusively determines the value of the interests for gift tax purposes.[8] The Tax Court's holding that the restriction is only one of several factors

determining value of gift tax purposes is a conclusion of law which we review di novo.

To prove that book value is conclusive, petitioners must establish that a withdrawal, one of the four events which activates the buy-out provision, occurred. Whether under the partnership

---

[8]The partnership agreements of 1973 and 1976 contained similar buy-out provisions which were applicable in the case of incompetence, bankruptcy, death, or "withdrawal" of a partner.

In the event of death or incompetence of a partner, the remaining partners may elect at their option * * * to form a successor partnership, in which event full payment shall be made * * * by said successor partnership * * * for the amount of the book value of the interest of such deceased or incompetent partner. (1973)

If any partner shall withdraw or be adjudicated a bankrupt during the existence of the partnership, the remaining partners shall have the same rights and duties as if the withdrawing or bankrupt partner had died upon such date * * * (1976)

agreement a gift is a withdrawal is a question of construction. The Tax Court held that a gift is not a withdrawal for several reasons. First, petitioners could have easily included a sale or gift in the list of events which trigger a buy-out provision. Second, the Tax Court found the "gift or sale is withdrawal" argument "bizarre, particularly in light of the fact that it would have been easy to require partners wishing to sell or to give away portions of their interests in HIC to first offer those interest to HIC at book value." The Tax Court noted that petitioners did not cite a single authority in support of their interpretation and contradicted that position by valuing Belva's 1/6th interest, which was given to Jack and Bud, at more than book value.

The value of the interests for

gift tax purposes is their fair market value. Fair market value is defined as the price at which such property would change hands between a willing buyer and a willing seller, neither of whom are under compulsion to deal and both of whom have reasonable knowledge of the relevant facts. 26 C.F.R. § 26.2512-1.

Restrictive provisions in a partnership agreement that determine the price at which the partnership will purchase the interest of deceased members are not binding on the Internal Revenue Service for gift tax purposes. Spitzer v. Commissioner, 153 F.2d 967, 970 (8th Cir. 1946); James v. Commissioner, 3 T.C. 1260, 1264 (1944), aff'd, 148 F.2d 236 (2nd Cir. 1945). Usually, restrictions to which a security is subject are only one factor to consider in valuing that security. Fred A Berzon v. Commissioner,

63 T.C. 601, 613 (1975), aff'd, 534 F.2d 528 (1st Cir. 1976). [O]ne rationale for refecting the formula price as an absolute determinative of fair market value is that such a figure does not represent the value of all of the rights inherent in * * * ownership * * *." Estate of Reynolds v. Commissioner, 55 T.C. 172, 190 (1970). The significance of a restriciton on transfer of securities in determining the value of those securities is dependent on the likelihood that the restriction will be activated. Thus, the value stated for sale of decedent's determines the value for tax purposes because "the critical event, the death of the holder of the shares, which subjected the stock to purchase for a price stated in the option, has occurred." Spitzer v. Commissioner, 153 F.2d 967, 970-71 (8th

Cir. 1946).

In contrast, the value listed in a buy-sell agreement triggered by the shareholder's death does not determine the tax value when shareholder had a 20-year life expectancy and the contract might terminate prior to shareholder's death. Spitzer, 153 F.2d at 971.

26 C.F.R. § 25.2512-3 directs that determination of net value of interests in business be made "on the basis of all relevant factors including-

(1) a fair appraisal as of the date of the gift of all the assets of the business, tangible and intangible, including good will;

(2) the demonstrated earning capacity of the business, and

(3) other factors . . . relating to the valuation of corporate stock, to the extent applicable."

Restrictions upon sale of insurance company stock, controlled by a voting trust, were only one factor determining the value of voting trust certificates because restrictions did not deprive certificate holders of all ownership rights. Estate of Pearl Gibbson Reynolds, 55 T.C. 172, 190 (1970). Certificate owners surrendered the right to vote and to transfer their stock but retained the right to receive dividends, to recover their shares upon termination of the trust, to hold the stock as an investment and receive any appreciation in its value. Id.

The Tax Court held that the interests at issue, "carried with them rights additional to the rights of their holders to receive certain payments upon withdrawal from HIC.[9] The Tax Court

[9]Harwood v. Commissioner, 82 T.C. at 261.

held that the restrictions did have a depressing effect on value and considered that factor in valuing the interests.

VALUATION OF INTERESTS

The Tax Court's application of the Federal Rules of Evidence is reviewed for abuse of discretion. Kalgaard v. Commissioner, 764 F.2d 1322, 1323 (9th Cir. 1985); Its findings of fact are reviewed under the clearly erroneous standard. Nunley v. Commissioner, 758 F.2d 372, 272 (9th Cir. 1985) Petitioners argue that the Tax Court's valuation of the HIC interests transferred in 1973 and 1976 is erroneous because the court failed to give proper credit to Harwood experts. The Harwoods also object to the admission of the Kleiner-Granvall report because they commissioned it and paid for it.

Harwood experts, Charles Stark and

Paul Kevin, valued the HIC interests transferred in 1976 based upon a capitalizaton of earnings approach, a capitalization rate of 5, and a comparison with HIC's earnings in the four preceding years.

IRS experts, Robert Kleiner and Raymond Granvall, submitted a report estimating the net value of HIC as of December 31, 1976. The report was prepared in 1977 at the Harwood family's request and expense and was based upon the comparable sales approach to valuation.

The Tax Court accepted the Kleiner-Granvall report valuation. The court held that Kevin failed to adequately justify his assumption and that the capitalization of earnings approach did not provide an accurate valuation because, in the forest products

industry, past performance did not accurately reflect future prospects. The court found that Stark failed to justify his selection of a capitalization rate of 5.

Petitioners' expert, Stark, testified that stock inpublicly traded forest products companies traded at a discount of 60% of their net asset value. IRS expert Bard placed the discount at 30%. The Tax Court rejected both figures and applied a 50% discount to reflect the fact that the interests being valued were minority interests, were not publicly traded, and were subject to restrictions.

The court accepted Harwood expert Kevin's valuation of the interest transferred to Suzanne in 1973. Taxpayers contend that the court also should have accepted Stark's valuation.

The court's findings of value are based on competent evidence. The court has clearly stated its reasons for rejecting some of Harwood's experts testimony. The court's findings are supported by substantial evidence and are not clearly erroneous.

The court did not abuse its discretion in admitting the Kleiner-Granvall report. Petitioners do not contend that the report's authors are unqualified or that the report is unsound.

We AFFIRM.

Filed May 28, 1986

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

VIRGINIA Z. HARWOOD, et. al.,	)C.A.Nos.
	)85-7091
Petitioners-Appellants,	)85-7092
	)85-7093
	)85-7094
vs.	)
	)Tax Court
COMMISSIONER OF INTERNAL REVENUE	)Nos.
	)6557-81,
	)6559-81,
Respondent-Appellee.	)6560-81,
	)6561-81
	)
	)ORDER
	)

Before: BROWNING, Chief Judge, and TANG and BEEZER, Circuit Judges

The panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no judge in active service has requested a vote to rehear the matter en banc.

Pursuant to Rule 35(b) of the

Federal Rules of Appellate Procedure, the petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

PROOF OF SERVICE

I, ELLEN TENUD, declare:

I am employed in the City and County of San Francisco, State of California. I am over the age of eighteen years and not a party to nor interested in the within action; my business address is 50 California Street, Suite 3150, San Francisco, California 94111. On September ~~10~~ 11, 1986, I served three true copies of the within PETITION FOR CERTIORARI by placing it in a sealed envelope with postage thereon fully prepaid, in the United States mail at San Francisco, California, addressed as follows:

Solicitor General,
Department of Justice,
Washington, D.C. 20530

I declare under penalty of perjury that the foregoing is true and correct.

Executed on the ~~20~~ 11th day of September, 1986 at San Francisco, California